McKenna Long & Aldridge LLP

Tangible and Intangible Asset Costs

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Agenda

- Depreciation/Capitalization Costs
- Gain/Loss on Sale Costs
- Rental Costs
- Patent and Intangible Asset Costs

Depreciation/Capitalization Costs

- Basics:
  - Depreciation is "***a charge to current operations*** that distributes the ***cost of a tangible capital asset***, less estimated residual value, over the ***estimated useful life of the asset*** in a systematic and logical manner" (FAR 2.101)
  - This means:
    - Asset is acquired/constructed
    - Costs accumulated (capitalized)
    - Asset placed into service
    - Capitalized amounts charged incrementally to current operations over "useful life" of asset

Depreciation/Capitalization Costs (cont.)

- Allowability (FAR 31.205-11)
  - If subject to CAS: Must be consistent with CAS 409
  - If not subject to CAS:
    - Capped by amount used for financial accounting purposes
    - Must be consistent with commercial practices
  - Not allowable if property is:
    - Acquired from the government at no cost
    - Fully depreciated (use charges may be negotiated)
- Allocability (CAS 409-40(b))
  - Allocation typically based on usage—may be measured by time
  - Typically indirect (commonly through facility pools)
  - May be direct in unusual circumstances

Depreciation/Capitalization Costs (cont.)

- Current Audit Issues: Capitalization
  - Process: Governed by GAAP / CAS 404
  - Amount Capitalized:
    - Determined by (CAS 404-50(a)):
      - Price (if acquired) or cost (if built)
        and
      - Costs necessary to prepare the asset for use
    - *Inter-Company Transfers*: Usually capitalized at cost (FAR 31.205-11(e)) (see discussion below)
    - *Assets Acquired Through Business Combinations*: Net book value (CAS 404-50(d))
    - Includes unallowable costs?

Full CAS Coverage: Capitalization and Depreciation

- Capitalization (CAS 404)
  - Contractor must:
    - Have a written policy that is consistently applied
    - Capitalize costs of tangible capital assets if (lower thresholds may be selected):
      - The asset cost exceeds $5,000; **and**
      - The expected useful life of the asset exceeds 2 years
  - Tangible capital assets may also include
    - Capital leases
    - Betterments / Improvements
  - Note: Changes in estimated useful life or value of an asset are not changes in cost accounting practice

Full CAS Coverage: Capitalization and Depreciation (cont.)

- Assets should be capitalized at the "cost to acquire" the asset
  - "All" costs should be considered, including the purchase price and any modifications to bring the asset into service
  - If self-constructed, allocable indirect costs should be applied
  - Assets acquired as part of a business combination are capitalized at net book value
  - Asset accountability units; components of plant and equipment separately capitalized

Full CAS Coverage: Capitalization and Depreciation (cont.)

- Records should be maintained to support acquisition value
  - DCAM: Review of asset cost may include "verifying . . . supporting documents such as purchase order, vendor invoice, and cancelled checks"
  - DCAA demands Part 15-type documentation to support asset value
  - CAS 409(e) does not specify exactly what records are required
    - Generally requires that the contractor maintain supporting records "which are adequate" to show the age at retirement or withdrawal from use for "like assets (or groups of assets) used in similar circumstances appropriately modified for specifically identified factors expected to influence future lives."
    - These factors include changes in physical usefulness such as quantity and quality of expected output and changes in expected economic usefulness such as technical or economic obsolescence.

Full CAS Coverage: Capitalization and Depreciation (cont.)

- Depreciation (CAS 409)
  - Depreciable cost is an asset's capitalized cost less the estimated residual value
  - Depreciation costs are assigned:
    - Across the estimated service life of an asset
    - Based on the pattern of consumption
    - IRS Asset Classes
  - Depreciation methodologies
    - Straight Line
    - Accelerated
      - Contractor burden to establish
      - Demonstrate departure from historical pattern
  - Allocation to final cost objectives
    - Direct when based on usage and directly identifiable with a single cost objective
    - Indirect in all other instances

Depreciation/Capitalization Costs

- Current Audit Issues: DCAA Audits of Depreciation Costs
  - DCAA focuses (DCAM 7-403.2, .3):
    - Policies and procedures
    - Asset cost/price
    - Challenge to contractor classification of asset and associated "useful life" (building improvements v. leasehold improvements)
    - Challenge contractor changes to useful life
  - Audits of policies and procedures
    - Key questions
      - Does the contractor have documented practices?
      - Are those practices consistent with FAR, GAAP, and CAS?
      - Are those practices followed?
    - Be proactive to avoid confusion between policies at the time of capitalization and current policies

Depreciation/Capitalization Costs

- Current Audit Issues: DCAA Audits of Depreciation Costs (cont.)
  - Audits of asset cost / price
    - DCAM 7-403.3: The auditor should determine if the capitalized asset cost . . . is supported by the contractor's accounting records. ***This may include verifying the cost of the asset to supporting documents*** such as purchase order, vendor invoice, and cancelled checks. It may also include reviewing the cost of betterments, as well as determining if asset retirements have been properly accounted for.
    - DCAA will expect records to remain in place for life of asset
      - Logic: FAR 31.201-2 requires support for claimed costs

Depreciation/Capitalization Costs (cont.)

- Best Practices Notes
  - Maintain CAS/GAAP-compliant practices for capitalization and depreciation
  - When constructing or acquiring a capital asset, maintain documentation of costs, ***including evidence of allowability and reasonableness***
  - Retain documentation of capitalized amounts for the full depreciable period
    - Ensure document retention policies permit this goal
  - Support terms of useful life different than identified in regs to years identified in regulations

Gain/Loss on Sale Costs: FAR 31.205-16

- Considered as adjustments to previously recognized depreciation costs
- Measured by <u>difference</u> between:
  - "net amount realized" (including insurance proceeds from involuntary conversions"); and
  - Undepreciated balance
- Land and improvements treated differently
- Involuntary conversions (fire, theft, etc.) also give rise to gains and losses if the property is not replaced

Rental Costs

- Basics
  - Covers costs of leasing real or personal property through operating leases (i.e., all leases that are not “capital”)
  - Same sale-leaseback rules as capital leases (FAR 31.205-36(b)(2))
- Allowability
  - Allowable if reasonable (FAR 31.205-36(b))
  - Special reasonableness considerations (FAR 31.205-36(b)(1))
    - Rental costs of comparable property, if any;
    - Market conditions in the area;
    - The type, life expectancy, condition, and value of the property;
    - Alternatives available; and
    - Other provisions of the agreement.

Rental Costs

- Capital Leases: GAAP (ASC 840) - Capital leases are leases that:
  - Transfer ownership
  - Include bargain purchase option
  - Cover more than 75% of useful life
  - Require payments of 90% or more fair value
- Allowability (FAR 31.205-11(h))
  - GAAP / FAR requires treatment as a purchased asset
  - When applicable, this means capitalization of costs and deprecation
    - Cost is lower of asset value or present value of payments

Rental Costs (cont.)

- Operating Leases:
  - Term is short compared to the useful life of the asset or piece of equipment
  - Commonly used to acquire equipment on a relatively short-term basis
  - Example: an aircraft which has an economic life of 25 years may be leased to an airline for 5 years on an operating lease.
- Allowability of Operating Leases
  - Rent for real property or personal property is generally allowable if the leases are determined to be operating leases under FAS No. 13

Rental Costs: Sale/Leaseback

- Allowability in Sale/Leaseback: FAR 31.205-36(b)
  - Rental costs only allowable up to the amount the contractor would be allowed if it retained title
  - Rental costs in excess of the imputed costs of ownership unallowable
  - Imputed cost based on the net book value of the asset on the date the contractor becomes a lessee of the property adjusted for any gain or loss recognized in accordance with 31.205-16(b)

Rental Costs: Common Control

- Present Issues: Entities Under Common Control
  - Allowable only to the extent that they do not exceed the normal costs of ownership (FAR 31.205-36(b)(3)), including:
    - depreciation
    - taxes
    - insurance
    - facilities capital cost of money
    - maintenance
    - mortgage interest?
  - Personal property may be leased at price (not cost) if the lessor has an established practice of leasing the same or similar property to unaffiliated lessees (FAR 31.205-36(b)(3))

Rental Costs

- When does common control exist?
  - FAR provides little guidance—determination is fact specific
  - Question is whether one entity could exercise ***actual*** control over another (*West Tool & Mfg., Inc.*, NASA BCA No. 53-0891, 93-2 BCA ¶ 25,763)
    - Ownership not essential (*Data-Design Labs.*, 85-1 BCA ¶ 17,825)
    - Vesting management responsibility in third party may not be enough (*Talley Def. Sys., Inc.*, 93-1 BCA ¶ 25,521)
  - Could an entity object to or refuse to implement the direction of the other? (*Data-Design Labs.*, 85-1 BCA ¶ 17,825)

Rental Costs (cont.)

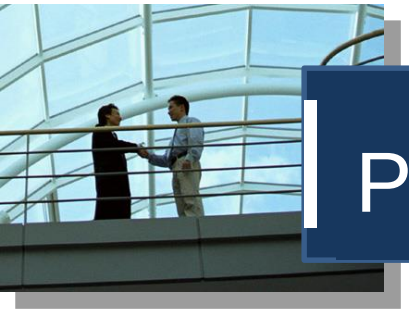
- Best Practices Notes:
  - Ensure rental agreements are documented through written contracts
    - Independent Review of Terms
  - Particularly if rental costs will be high, document reasonableness using FAR's rental cost reasonableness criteria
  - If any affiliation exists between lessor and lessee, assess for common control
    - Be conservative—audit risk is high
    - Document conclusions
  - Seek Advance Agreement?

Patent and Intangible Asset Costs

- Patent Costs (FAR 31.205-30; FAR 31.205-37; FAR 31.205-47(f)(6))
  - Allowable if incurred as a requirement of a Government contract, *e.g.,*
    - invention disclosure reports
    - filing and prosecution of U.S. patent application where title to be conveyed to U.S.
  - General counseling (on laws, regulations, clauses, employee agreements) allowable
  - Other patent prosecution and patent infringement litigation costs unallowable
  - Royalties (direct/indirect) in excess of $1500 must be detailed in proposals; allowable subject to limitations and refund provisions

Patent and Intangible Asset Costs (cont.)

- Intangible Assets
  - Development Effort For Items Intended for Sale (FAR 31.205-18; CAS 420)
    - Independent Research & Development ("IR&D") costs are expensed in the fiscal period incurred and allocated on the same basis used for G&A expense
    - IR&D does not include cost of effort:
      - "Sponsored by a grant or required in the performance of a contract" or
      - For manufacturing or production materials and/or other items not intended for sale (*e.g.,* FAR 31.205-25, Manufacturing and production engineering costs)
    - Deferred IR&D (e.g., capitalized product development costs)
      - Unallowable, narrow exception for certain specific product development costs



Patent and Intangible Asset Costs (cont.)

- Intangible Assets (Cont.)
  - Computer Software
    - In the absence of controlling CAS or FAR, GAAP governs
    - Software sold, leased, or otherwise marketed (ASC 985-20; DCAM 7-106)
      - Generally, software development costs expensed until software product "technical feasibility" is established
        - » Costs post-technical feasibility must be capitalized until the product is available for release to customers
        - » Capitalized costs amortized over future software product sales
      - Accordingly, computer software development costs are likely IR&D costs until "technical feasibility" is established, meaning:
        - » Detailed program design is completed OR
        - » A working model has been developed

Patent and Intangible Asset Costs (cont.)

- Intangible Assets (Cont.)
  - Computer Software (Cont.)
    - Internal use software (ASC 350-40; DCAM 7-103, -104, -105)
      - Costs should be capitalized beginning shortly after completion of concept formulation and planning
      - Capitalization should cease, and amortization should begin, when the computer software project (or relevant component) is substantially complete and ready for its intended use
      - Amortization method should be same as contractor's normal practice or any reasonable method

Patent and Intangible Asset Costs (cont.)

- Intangible Assets (Cont.)
  - Goodwill
    - Intangible asset created when a purchaser pays the seller more than the fair market value for assets in a business combination
    - Unallowable
  - Asset value step-up in business combinations
    - GAAP requires step-up in value of assets
    - Unallowable

Patent and Intangible Asset Costs (cont.)

- Current Audit Issues
  - Alleged unallowable legal and other costs relating to patents not required under government contract(s)
  - IR&D costs allegedly required in the performance of a contract
  - Assignment and/or reasonableness of intangible asset and/or software amortization costs; cost-based pricing of software product

Patent and Intangible Asset Costs (cont.)

- Best Practices Notes
  - Follow consistently established accounting practices for IR&D costs, Intangible Asset and Software Amortization and Patent Costs
  - Document and retain evidence of acquisition value and "technical feasibility," substantial completion and other relevant accounting milestones
  - Carefully scrutinize allowability determinations for costs relating to Patents, Royalties and Intangible Assets

Questions?

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